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Financial Market Restructuring

Despite the sharp decline in equity markets around the world and the ensuing volatility of exchange and interest rates, the Ministry of Finance will continue to push ahead as planned with financial market liberalization and deregulation. In fact, the recent volatility and the relative ease with which domestic financial institutions weathered the storm is being cited as evidence that Japanese companies are fundamentally sound and that MOF can proceed without undue concern. With deregulation of interest rates well under way, the ministry's focus is shifting to structural reform of the financial sector.

The following developments have taken place or are under discussion:

- Instruments with market-determined interest rates - MOF is continuing its efforts to put financial instruments with unregulated interest rates

• Insider trading rules - On October 19 MOF's Securities and Exchange Council established a special panel to regulate insider trading and other fraudulent securities transactions. The panel's first order of business was to propose new legislation to strengthen the government's powers to monitor and punish unethical trading practices. MOF's actions come on the heels of the Tateho Chemical Co., Ltd.'s bond futures trading scandal that rocked markets in September and October. It was determined that company and brokerage officials with inside information about Tateho's huge bond trading losses sold large blocks of Tateho stock before the information was made public. Nevertheless, no charges were filed.

• Foreign participation in government bond sales - After some delays due to chaotic market conditions, the Finance Ministry held its first auction of 10-year bonds November 12, awarding foreign firms 16.6 percent of the Y140 billion ($1 billion) offering. Combined with the sale of the remaining Y560 billion ($4 billion) worth of 10-year bonds through the traditional bond syndicate, foreign firms won a total of 4.6 percent of the Y700 billion ($5 billion) sale, well above their 1.6 percent share of the previous bond sale. According to press reports six foreign firms bid for the maximum Y7 billion ($50 million) worth of bonds allowed to any one firm under the auction system. Since all bids totaled over Y330 billion ($2.4 billion), MOF scaled back the maximum allotments to just under Y3 billion ($21 million).

MOF is currently grappling with the issue of reforming Article 65 -- the Japanese equivalent of the Glass-Steagall Act -- to allow banks and securities companies to compete directly against each other. Although progress in Congress toward repealing the U.S. law appears stalled by recent stock market gyrations, MOF seems to be moving ahead cautiously. Its approach is to allow banks and securities companies to compete directly through arms-length subsidiaries on a limited, experimental basis. In addition, the government would break down the traditional distinctions between banks before taking down the barriers between banks and securities firms. MOF's decision to allow foreign banks to co-own Japanese securities operations and to allow IBJ's Schroder unit to bid for a TSE seat is evidence that the first step has been accomplished. MOF is now beginning the second phase of reshaping the banking industry by forcing the 69 mutual savings (sogo) banks (which traditionally focused on small business loans), three long-term credit banks, 13 nationwide commercial banks and the Bank of Tokyo to shift and consolidate operations. Once the restructuring is complete and assuming the bank/securities company experiments are successful, MOF will move on Article 65. It will take some time to reach this stage, however, and officials are not likely to change their incremental approach even if the United States repeals Glass-Steagall.

Jon Choy

Japan's Monetary Expansion Continues

The Bank of Japan released preliminary figures November 9 that indicate the money supply continues to grow rapidly. The most widely watched measure of money, M2+CDs, grew 11.1 percent in September compared to the same period a year earlier. For the July-September quarter, preliminary figures indicate a 10.8 percent year-to-year change. Both figures are higher than previous periods.

Changes in Japan's Money Supply

(percentage change from year-earlier figures)

	M2+CDs
FY 1986	8.6%
1987 April	9.8
May	10.2
June	10.0
July	10.3
August	11.0
September	11.1

As the table shows, however, the money supply has been growing rapidly for some time. Much of the increase has gone toward the purchase of assets such as land rather than for current production, and therefore has not had the stimulus effect that might be expected. Real estate loans accounted for about 29 percent of the increase in M2+CDs in fiscal 1986. This partly explains why land prices, particularly in the big cities, have risen rapidly even while the overall rate of inflation at the wholesale and consumer level has been remarkably low.

There are a few signs, though, that inflation might begin picking up. Capacity utilization has been rising, commodity prices are starting to increase and some shortages are showing up. Wholesale domestic prices, which fell 2.4 percent in the October-December 1986 period from the previous quarter, dropped again by 0.6 percent in the first quarter of this year. They were unchanged in the April-June quarter but increased 0.9 percent in the quarter ending in September. October's prices were unchanged from September's.

Until mid-October policymakers were allowing interest rates to creep up, but the stock market crash in the United States and elsewhere would appear to reduce the options available. For one thing the more or less simultaneous stock market declines around the world heightened the sense that national economies are linked. Even more than usual, Japan now has to take U.S. policy into account in formulating its position.

In the United States the Federal Reserve Board was clearly moving toward a more restrictive policy prior to the crash in order to head off inflation. The crash was a clear signal to change course and the Fed immediately loosened monetary policy, choosing to gamble with the possibility of inflation. Washington's decisions reflect an increasingly political context as the president enters his last year in office. Economic decisions made now will determine to a substantial degree the environment on election day.

The Japanese find themselves at a different point in the political cycle. The new Japanese government might be expected to take a longer view if only because it is new and does not face an election that would reflect on its economic policy. A longer view in this case would probably persuade political leaders to put more emphasis on fighting inflation than on preventing a downturn in the economy.

In short, Japanese monetary policy is at something of a crossroads. If rapid money growth continues there is a perceived risk of inflation. If money growth slows too much, Japanese interest rates could rise and economic growth could slow. The current account could then stop shrinking, with negative consequences for relations with the United States.

Douglas Ostrom

Japan-EC Relations Looking Up

Relations between Japan and the European Community continue to fluctuate, although the tensions common to U.S.-Japan relations are generally absent. One reason for this is that bilateral trade represents a relatively small portion of each side's overall trade. Another is that EC exports to Japan have been growing at a faster rate than imports from Japan during the past several months. Nevertheless, Japan and the EC find themselves at odds over a wide range of issues while at the same time finding common ground on others.

The bilateral debate over Japan's alcoholic beverage taxes seems to be at a key point. The EC has long complained that the Japanese tax system hampers foreign suppliers of wines and spirits. Last February the General Agreement on Tariffs and Trade began an investigation under Article 3 (nondiscriminatory taxation) at the EC's request. On November 10 the GATT asked Japan to revise its liquor tax system to end discrimination against foreign products. The council pointed to four areas to be reformed: the whiskey and brandy grading system; the structure of the ad valorem tax on wine, spirits and liqueurs; higher taxes on foreign liqueurs than on domestic products; and the low tax on shochu, a domestic liquor. The council rejected an EC argument that Japan's beverage labeling laws also violated Article 6 of the GATT code, which calls on members to prevent misunderstandings on the origins of products.

The Ministry of Finance had actually proposed many of these reforms as part of a fiscal 1987 tax package (see JEI Report No. 20A, May 22, 1987). Due to a Diet impasse over other parts of the tax bill, however, the proposed adjustments never came to a vote. After the GATT ruling MOF said it would try to obtain quick passage of a reform bill by submitting it separately from the controversial tax package. Willy De Clercq, EC commissioner in charge of external affairs, welcomed both the GATT decision and MOF's plans, and said he hoped that liquor exporters would take advantage of any changes.

Japan and the Community are also on opposite sides at the GATT on several other issues. The EC wants the GATT to pressure Japan to drop its controls on semiconductor prices that it agreed to under the 1986 U.S.-Japan semiconductor accord. A panel was convened in April to decide whether Tokyo's actions violate GATT Articles 1 (the most favored nation clause), 6 (the antidumping and countervailing-duty clause) and 11 (the abolition of quantitative restrictions). While Washington is satisfied that the pact is yielding dividends, the EC continues to rail against it as trade-distorting and harmful to EC economic interests. Tokyo's position is that the EC has not been discriminated against under the agreement and that the provisions to monitor chip prices in third-country markets do not contravene GATT rules. The GATT panel is continuing its investigation with testimony from chip-importing nations such as Singapore.

The EC's decision to strengthen antidumping rules to include parts and subassemblies of items such as photocopiers and videocassette recorders continues to irk Japanese industry. Japanese corporations have been setting up assembly plants on the continent in an effort to contribute to the local economy and avoid EC import controls. After European companies complained that these transplants were only "screwdriver" factories, the EC decided to take a harsher stance. Japan is still considering taking the issue before the GATT but hopes that a negotiated settlement can be found.

Forming a backdrop to these disputes are bilateral trade statistics showing healthy growth. The growth rate disparity between Japan's imports from and exports to the Community is surprisingly large. For example, September's dollar-based imports rose 19.3 percent while exports grew less than half this at 8.6 percent. Nevertheless, the bilateral trade imbalance has widened during the first nine months of 1987 from $13.3 billion in 1986 to $15.3 billion because Japan's exports to the EC are more than double imports.

Although some trade issues remain sensitive, such as European disappointment that Tokyo did not allocate any of its emergency buying package for European aircraft (see JEI Report No. 41B, October 30, 1987), both sides consider relations to be on the upswing.

Jon Choy

Update On Japan-Latin America Relations

Tokyo's plan to recycle $20 billion of its current account surplus to the developing countries (see JEI Report No. 21B, June 5, 1987) has given a prominence to Latin American countries heretofore unparalleled in Japan's foreign policy. The recycling initiative, which is designed to assist major debtor nations (primarily in Latin America and Asia), has catapulted Latin America to a position of greater importance to the government.

Until relatively recently Latin American countries held a minor role in Japan's foreign policy considerations, largely because the region's proximity to the United States seemed to make it Washington's responsibility. Several factors have combined to elevate Latin America's importance to Tokyo, however, including its one million Japanese residents (mainly in Brazil, Paraguay, Peru and Mexico), rich supply of natural resources, and the increasing pressure on Tokyo to expand its foreign aid flows to non-Asian areas.

Partly as a result of these factors, Japan's economic presence in Latin America has been steadily expanding. Exports have skyrocketed by 89 percent since 1976 (in dollar terms), while imports have jumped by over 150 percent (see Table). As with many other developing countries, the overwhelming majority of exports consists of machinery and other industrial goods, while imports are primarily agricultural and industrial raw materials.

While the appreciation of the yen has made investment opportunities less expensive, government officials are pessimistic about the likelihood of significant increases in the near future. Japan's private sector cites high inflation rates in the region, political instability (including the threat of nationalization), and economic crises as disincentives to investment. Indeed, more than half of Japanese ventures consist of "paper investments," such as Panamanian ship registrations.

Japan's Trade with Latin America: 1966, 1976, 1984-86

(in millions of dollars, exports f.o.b./imports c.i.f.)

	1966	1976	1984	1985	1986
Colombia					
Exports	$23.7	$162.8	$403.6	$422.1	$385.9
Imports	8.4	60.7	152.2	150.4	267.1
Trade Balance	15.3	102.1	251.4	271.7	118.8
Mexico					
Exports	50.2	385.9	887.9	994.0	1,032.0
Imports	177.7	248.2	2,259.8	1,869.9	1,439.0
Trade Balance	-127.5	137.7	-1,371.9	-875.9	-407.0
Panama					
Exports	63.5	1,304.5	3,444.0	3,326.1	3,196.8
Imports	8.7	35.5	167.9	81.3	83.7
Trade Balance	54.8	1269.0	3,276.1	3,244.8	3,113.1
Cuba					
Exports	6.5	199.5	250.3	300.9	292.7
Imports	22.2	50.3	78.0	92.3	131.1
Trade Balance	-15.7	149.2	172.3	208.6	161.6
Venezuela					
Exports	62.6	562.8	347.7	352.1	516.0
Imports	25.0	33.5	467.3	367.7	335.3
Trade Balance	37.6	529.3	-119.6	-15.6	180.7
Peru					
Exports	57.0	143.9	160.1	140.6	224.3
Imports	124.1	232.1	407.3	331.9	326.0
Trade Balance	-67.1	-88.2	-247.2	-191.3	-101.7
Chile					
Exports	23.1	77.2	290.9	168.6	294.4
Imports	149.4	298.3	634.7	533.7	534.6
Trade Balance	-126.3	-221.1	-343.8	-365.1	-240.2
Brazil					
Exports	44.0	881.6	639.5	614.9	973.1
Imports	60.6	818.6	1,990.8	1,840.2	1,874.6
Trade Balance	-16.6	63.0	-1351.3	-1225.3	-901.5
Argentina					
Exports	30.6	232.7	391.7	225.4	361.0
Imports	53.3	253.2	489.1	443.0	503.3
Trade Balance	-22.7	-20.5	-97.4	-217.6	-142.3
Other					
Exports	195.2	1,061.7	1,732.9	1,941.1	2,218.3
Imports	151.6	434.4	583.2	531.8	698.9
Trade Balance	43.6	627.3	1149.7	1409.3	1519.4
Total					
Exports	556.4	5,012.6	8,548.6	8,485.8	9,494.5
Imports	781.0	2,464.8	7,230.3	6,242.2	6,193.6
Trade Balance	-224.6	2,547.8	1,318.3	2,243.6	3300.9

Source: Japan Tariff Association, The Summary Report: Trade of Japan

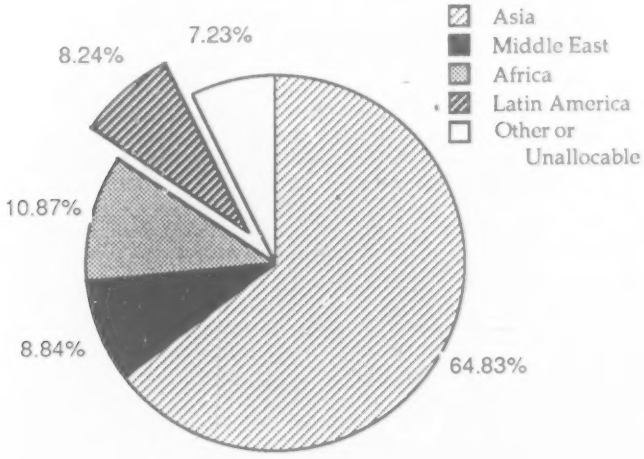
Still, Tokyo continues to stress the development of free market conditions and transfers of technology to promote economic stability in the region. To this end the government has set in place various programs to insure companies against non-commercial risks and to facilitate debt-equity swaps in the region. Investors remain reluctant to make new commitments, however, and Tokyo has said that Latin American countries must provide conditions that are more conducive to investment.

But the region's debt problems remain the number-one issue for Japan. Japanese banks reportedly have the second-largest exposure to these debts, holding mainly Mexican and Brazilian loans. As the threat of major defaults has become more worrisome during the past year, Tokyo has made a high-visibility effort to propose new ways to respond to the debt crisis. Its most notable initiative was a $30 billion three-year aid plan, $10 billion of which consists of subscriptions to multilateral lending agencies and $20 billion to be recycled from Japan's public and private sectors. Tokyo has also taken measures to shield its banks from loan losses by approving the establishment of a paper company in the Cayman Islands to buy a portion of nonperforming Mexican loans at a discount (see JEI Report No. 11B, March 20, 1987).

On the multilateral front, officials have indicated their willingness to consider coordination of debt-equity swaps and the establishment of a multilateral debt-purchasing organization. They have also urged ratification of the convention establishing the Multilateral Investment Guarantee Agency (see JEI Report No. 22B, June 12, 1987). To date, Japan is the only industrialized country that has officially approved MIGA. (For a more detailed discussion of Japan's policies concerning the Latin American debt crisis, see JEI Report No. 29A, July 31, 1987.)

Although Tokyo continues to search for creative ways to alleviate debt and development problems in Latin America, it also admits that official development assistance is of limited use in the region. High per-capita income in many countries makes them ineligible for aid. Consequently, even though bilateral aid flows to the region continue to increase, in 1986 they accounted for only 8 percent of Japan's total bilateral disbursements -- less than Asia, Africa and the Middle East (see Figure).

Japan's Foreign Aid by Region, 1986



In light of this obstacle, Tokyo hopes to craft a solution that actively involves the private sector. The 1987 White Paper on International Trade suggests that "Japan should take steps to create an environment in which its current account surplus can be returned to private hands through the mechanisms of the market and flow back smoothly to the debtor nations." The question is whether Latin American countries can offer an investment environment attractive enough to persuade Japanese investors to implement Tokyo's strategy.

Eileen M. Doherty

High Public Support For New Government In Japan

A series of opinion polls published November 12 and 13 in Japan indicates a broad level of popular support for the new government of Noboru Takeshita and suggests that the public expects action on domestic issues rather than foreign policy areas. The surveys show 48 percent of respondents supporting the new government and 22 percent opposing it. This compares favorably with initial surveys for other recent cabinets and is far higher than the first polls for the Nakasone government in 1982 that showed opinion evenly divided at 37 percent for and against the new lineup. Of the last nine governments, the Takeshita regime comes into office with the fourth-highest support level.

A related survey in the Asahi Shimbun -- Japan's second-largest daily and usually considered its most liberal -- showed that voters were interested in three domestic issues: price stability, tax reform and the business climate. Less than 10 percent of those polled thought foreign policy should rank as the government's first priority. Despite this, respondents apparently have very low expectations of the new regime. Nearly 80 percent indicated that they anticipated no changes for better or worse in their personal economic conditions under the new government.

One of the most interesting conclusions of the polls is the overwhelming approval for the consensus style of Mr. Takeshita over the presidential, assertive leadership of Yasuhiro Nakasone. Approximately 70 percent indicated this preference, which stands in marked contradiction to the consistently high public support ratings for the Nakasone government after its first year in office. In fact, after Mr. Nakasone backed off from his politically unpopular proposal for a 5 percent value-added tax, public support for his government rebounded, reaching the 40 percent level in some surveys. The explanation for this divergence might be a fondness for traditional views favoring the consensus decisionmaking process, while separately, the image of Mr. Nakasone as a strong leader who projected a positive image of Japan in the international sphere was undeniably appealing.

Michael W. Chinworth

House Rejects Attempt To Strike Gephardt Amendment

The House of Representatives rejected Minority Leader Robert Michel's (R, Ill.) November 10 attempt to strike the trade bill's controversial Gephardt amendment, which Michel said would lead to "mandatory and unilaterally imposed